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**LYNN UNIVERSITY.
COLLEGE OF BOCA RATON.**

**A STUDY OF RUSSIA AND THE
OPPORTUNITIES IT OFFERS FOREIGN INVESTORS.**

BLEAK STATISTICS, BLEAK POLITICS.

**A DISSERTATION SUBMITTED TO
Dr. F.P. BUTLER, FACULTY MEMBER
GRADUATE SCHOOL OF BUSINESS
IN CANDIDACY FOR THE DEGREE OF
MASTERS IN INTERNATIONAL BUSINESS.**

**BY,
PRITHVI RAJ URS.**

**BOCA RATON, FLORIDA.
APRIL 1995.**

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ABSTRACT.

Russia has experienced two momentous revolutions during the twentieth century. The overthrow of the czar in 1917 began the first. After a brief attempt at democratic rule, Lenin's Bolshevik Communists seized power in 1918 and established a totalitarian government, naming the remade Russian empire as the Union of Soviet Socialist Republics.

The seeds of the second revolution were sown with the elevation in 1985 of the reform minded Mikhail Gorbachev to the leadership of the Soviet Communist Party. His reforms, including perestroika (restructuring) and glasnost (openness, including limited democracy) unleashed strong forces within the Soviet Union. The revolution that Gorbachev's reforms promoted-or at least contributed to-reached a crisis stage in 1991.

The old guard communist party leaders, whose positions of power were being threatened by both perestroika and the demands of many of the Soviet Union's constituent republics for greater autonomy, staged a coup against Gorbachev on August 18. The coup collapsed within days, however, in part because hundreds of thousands of Soviet citizens took to the streets to rally against it. Boris Yeltsin, the president of Russia (then a Soviet republic), was the most visible symbol of democratic defiance of the old guard.

In the aftermath of the crisis, the already weak Soviet state lapsed into a terminal coma. Central authority dissipated. Real power shifted rapidly to Yeltsin's office in the Russian White House and to the other 14 republics, which moved rapidly toward independence. On December 25, 1991 the Soviet flag was lowered for last time from atop the Kremlin and the Russian flag was raised in its stead.

Of the former Soviet republics (FSU's), Russia is by far the largest, and the most powerful. Russia has retained all the Soviet Union's tactical nuclear weapons and the vast majority of its strategic-range nuclear weapons. These factors make the course of Russia a matter of great concern for the world.

It is the purpose of this paper to explore the history of the reform process, the current political and economic situation in Russia, the process in establishing free market mechanisms and the realities in opportunity for foreign direct investment in Russia.

**A STUDY OF RUSSIA AND THE OPPORTUNITIES IT OFFERS FOREIGN
INVESTORS.**

BLEAK STATISTICS, BLEAK POLITICS.

CHAPTER I: INTRODUCTION.

I

INTRODUCTION

In one of his early short stories, "Martyona's Home," Aleksandr I. Solzhenitsyn wrote a hauntingly prophetic passage about a prisoner coming home from the labor camps :

"in the summer of 1953 I was coming back from the dusty desert , just following my nose - so long as it led me back to European Russia. Nobody waited for me at any particular place, because I was a little matter of ten years over due. I just wanted to efface myself, to loose myself in deepest Russia.... if it was there."¹

Solzhenitsyn will in a sense be following his nose back to European Russia, the question is whether there is a Russia that waits or wants him, and whether his "deepest Russia" is still there. Solzhenitsyn has left no doubt of his ardent longing to devote his authority and his final years to help his beloved motherland recover from the ' plague of communism' .

As to whether "deepest Russia" is still there, for most part of the Russian hinterland remains much as Solzhenitsyn left it - muddy, backward, provincial and poor. But Russia has changed and changed dramatically, a state in which a tyrannical system ordered everything and in which every life was caught in compromises and small lies. But the tyranny also showed human traits - conscience, courage, weakness, cynicism - in far sharper relief, much as war exposes strength and cowardice. Every Russian was confronted with endless choices between integrity and compromises, and there were none who escaped unscathed. Most people simply struggled to maintain the modicum of personal integrity in the face of the state's demand for fealty. It was a harsh and cruel world, but also one in which whispered truths and smuggled books carried weight greater than money or status, in which people of conscience forged powerful bonds and defiance was a mark of greatness.

INTRODUCTION TO RUSSIA: The USSR, spanning eleven time zones and covering one sixth of the world's land sources is geographically the largest country in the world. About one quarter of its territory falls in Europe and the remainder in Asia.

In recognition of national differences, the USSR broke up and was divided administratively into 14 republics. Russia, which was officially called Russian Socialist Federative Soviet Republic,

¹ New York Times May 29, 1994.

embraces both the major ethnic Russian concentration and vast but sparsely populated territories in Siberia, the Arctic and the Far East. Russia accounts for three quarters of the total area and half the total population of the Former Soviet Union (FSU).

Independent Russia is the worlds largest country and the fifth most populous. Russia area totals 17,075 thousand sq. kilometers of 76.2% of the FSU. The total population is 148,041,000 or 51.3% of the FSU. The population is concentrated at 8.7 persons per sq. kilometer and is 74% urbanized.

Russia is extremely rich in natural resources. Extensive areas are ideal for agriculture, especially the famous "black soil" belt. Forests cover over half of the FSU with an overwhelming share located in Russia, which accounts for 52% of the total timber production. Fuel and natural resources for which the FSU is extremely rich are mainly concentrated in Russia.

Over 60% of NMP is generated in Russia, with an additional 20% originating in Byelorussia and the Ukraine. In agriculture Russia and the Ukraine generate 68% of total value added. Russia has the highest levels of foreign economic activity amounting to 9% of the NMP in 1988. Russia's per capita income was also among the highest at 110% of the FSU average.

PRE-REFORM RUSSIA. After achieving high rates of growth by world standards in the 1960's the Soviet economy entered a period of decline in the 1970's. NMP official growth rates for Russia averaged 7.8% in the 1960's and the fell to 4.4% in 1971-85 and only 2.7% in 1986-89. On a per capita basis the last two periods showed growth of 3.5% and 1.7% respectively. Since the official statistics were always exaggerated the real decline must have been even more significant.

Overall the figures can only give a limited understanding of the real economic situation that eventually forced the reforms. For an average Soviet citizen the quality of life visibly deteriorated in the 70's and 80's. In addition the Soviet Union found itself economically and technologically unable to compete with the United States for world dominance. Long driven by the dreams for world domination , the Soviet Union found themselves falling behind, especially after Reagan's military buildup and the "star wars" program. Continuing the competition meant total economic collapse at home which the totalitarian system could not afford.

THE REFORM PROCESS. The reform process in Russia cannot be characterized as a set out or coherent reform program. It began as an experiment to preserve the Soviet Union by Gorbachev, but soon

deteriorated into a haphazard process of changes in the economy and the political system of the country conducted by several consecutive governments.

Soon after assuming his post Gorbachev began his first effort to improve the situation. The program termed "acceleration", was designed to revive economic growth by tackling three of the perceived major defects in the economy, inefficiency, poor quality and lagging technological development. Although the problems to be addressed were systematic in nature the strategy remained an effort to improve the functioning of the existing system, rather than to change it fundamentally. First, a major re-tooling of the industry was planned. Second, a strenuous quality improvement program was implemented. Third, a series of measures were taken with the intention of stimulating the "human factor" by personal changes, and work incentives in the industry.

This campaign, however, quickly ran into a series of problems. This policy of "acceleration" failed at an early stage in 1987. A more serious push began in 1987, the goal remained the same, which was to improve the existing system. Two other major changes were made in 1987. First, firms were allowed to negotiate "contract" prices for new goods. Although there were strict controls on these prices the move was designed to encourage production of needed goods. However, the limits proved to be too strict to induce any visible improvements. Second, private ownership in the form of cooperatives was allowed. This had some effect in creating private sector jobs and some needed consumer goods but the limitations and obstructions by authorities prevented cooperatives from playing a significant role until 1990.

Under Gorbachev the reform was limited to delegation of more authority to state owned enterprises, some liberalization of the private economic activity and more rights and privileges granted to local administrations and other republics as well as relaxation of political control over the population. At this time Gorbachev tried to preserve some versions of a command socialist economy and a reworked version of the Soviet Union.

The disintegrating economic situation in Russia and the rise of nationalist tensions motivated local governments to pursue independent policies, introduce border customs and patrols, visa requirements, tariffs and export regulations. The gradual collapse of the Rouble began in 1989, and the worsening economic situation were essentially instrumental in motivating the Republics to try and achieve control over their economies by issuing their own currencies. As Gorbachev had not believed in the concept of a market economy, his attempts at reform were counterproductive. By

August 1991, he had reviewed and rejected 13 reform programs, including the radical "500 day" plan of September 1990. Thus, having made very little progress with reforms, Gorbachev was forced out. But, as many say, Gorbachev's greatness lay in his capacity to destroy everything he tried to save - his party's monopoly on power, its ideology and its empire.

REFORMS UNDER YELTSIN AND GAIDAR. Trying to give impetus to the Union Treaty Gorbachev acquiesced to the election of the President of Russia while himself remaining President of the Soviet Union. Gorbachev in fact was holding an empty crown. Yeltsin was soon elected as Russia's first President in June of 1991 on reform platform. With the collapse of the Soviet Union and Gorbachev's departure he got a free hand at reform. He appointed a economist Gaidar as Prime Minister and the latter pressed on with a radical but disorganized reform plan. Their aim was to break down everything and then re-build. The reform package was radical and included a radical price liberalization and massive privatization program. This reform program was based on stringent requirements of the IMF regarding macro-economic stabilization, price liberalization, financial and credit-monetary policy. Prices on monopolies were lifted. With these price rises the government eliminated most shortages plaguing Russia. By cutting the budget deficit they avoided hyperinflation. Concurrently the privatization scheme was initiated.

In 1992 the fall in production began to resemble disintegration . The overall drop in production reached 18%. In addition , instead of a deficit less budget promised by the government as late as the first quarter of 1992 the federal budget deficit rose to nearly 10% of the GDP. The non-payment in the economy reached 78% of the GDP. Taxes became too oppressive for whatever private enterprises there were. The Congress and the Central Bank began printing money in droves and extending massive amounts of credits to the industrial enterprises. This eased the non-payment crises and was popular in the industrial sector, but fueled a sudden rise in inflation. This in turn led to the collapse of the Rouble in dollar terms. This process has been colorfully, if somewhat skeptically, described as a "not the birth of a market economy, but a gigantic fire sale of the Soviet Union. Ex-communists, their 'reform-minded', children, and western carpetbaggers have got in on the hugest asset stripping operation in history."²

The success of the neo-fascists and former communist parties including the communist parties and the agrarians (rural

²ruble or rubble? time, October 1994.

communists) forced Yeltsin to retort to a more nationalistic stance and to slow the reform process designed to soften the socio-economic impact on the population. In the process reformers like Mr. Gaidar and Mrs. Fedorov quit the government and remained the leaders of the largest party in the Duma - reform Russia's Choice.

The composition of the Russian State Duma (lower house of parliament) after the December 15, 1993 elections.³

Party	% Votes	Seats	Plus single constituency	Total seats
Russia's Choice	15.38	40	30	70
Liberal Democrats	22.79	59	5	64
Communist	12.79	32	16	48
Agrarian	7.90	21	12	33
Yablokoo	7.83	20	3	23
Civic Union	1.92	0	1	1
Democrats	5.50	14	0	14
Dignity & Charity	0.70	0	2	2
Russian Unity	6.76	18	1	19
Women of Russia	8.10	21	2	23
Russian Movement for Democratic Reform	4.06	0	4	4
<hr/>				
Parties not listed			14	14
Independents			129	129

THE NEW CONSTITUTION. The newly ratified Russian constitution is now the supreme law of the Russian Federation on which all other laws and regulations will be based. It is necessary to be familiar with the major premises of this constitution to understand the possible course of further development of the reform process.

The constitution establishes the principle of three branches of government, but with a strong presidency, rather like the French Republic. Under a list of transitional provisions, laws and other legal acts adapted before the new constitution takes effect, are to continue in force to the extent that they are not in conflict with the new constitution.

³what is russian for free press? economist, January 1994.

When Yeltsin unveiled the final draft in a nationwide television address on November 9,, 1993 he said that Russia needs 'a durable legal order.' The constitution finally clearly defines the separation of power between the president and parliament, it sets rights, proclaims some free market business principles and establishes an independent judiciary. This should be of comfort to Russian democrats and foreign investors alike. However, there is a possibility for further conflict since the new Federal Assembly may begin to chafe under a constitutional structure that creates a strong presidency. The strong relationship between the federal government and the regions was also changed to create a stronger center, which is likely to create a source of ongoing tensions with the local authorities that have grown to like the nearly total lack of central control during the last two years. The final draft drops references to local sovereignty, which will anger the localities and the minorities.

The constitution guarantees a wide array of free market oriented business principles including the right to own land and other property, right to free movement of resources, protection from expropriation and for intellectual property.

REFORM PROGRAM FOR 1993-1995. In August 1993 The Russian Federation Government set forth a working version of its Reform Program for 1993-1995. In the document the current situation was characterized by an unstable balance. Although the rapid decline of the Russian economy has been halted along with the possibility of economic growth there is a danger for a relapse into further decline. Accordingly the government has to aggressively continue its reform efforts in order to push the economy towards growth in the nearest future.

The main reform efforts of the government are tied into its anti inflationary measures. To this goal the Russian government has reached an agreement with the Central Bank to slow the growth of the money supply. In addition several measures have been adopted to combat an inflationary rise in the budget deficit. The government has eliminated some ineffective social programs, proposed an across the board 15% spending cut and a moratorium on new spending on the spending side. On the revenue side the government will impose a new tax on natural gas production, raise to 30% a tax on oil production and institute new measures designed to combat tax evasion.

Another major aspect of reforms is the privatization program. The main goal is to convert state enterprises into joint-stock companies which will include not only the manufacturing facilities

but also the research and development and engineering centers. Despite this relatively gloomy short term forecast many believe that the long term outlook remains promising. The reform program has made an irreversible transformation of the Russian economy and produced a large shift to privatized enterprises, and at the very least a market oriented economy and a democratically minded society.

AGRICULTURE. Agriculture remains a very important part of the Russian economy. While there is tremendous potential in this sector it remains ineffective and wasteful. Prior to the 1917 revolution Russia was an exporter of grain and other agricultural produce. Now it imports over 15% of its annual needs consuming most of the available foreign currency reserves. Until the agricultural sector begins feeding the Russian population the economic situation will remain difficult.

Towards the end of 1992 Gaidar informed the public that free pieces of land would come into effect from 1993. Since then a significant number of state farms have been privatized. In the summer of 1993 private farmers accounted for 600,000 (about 7%) of the 9.9 million agricultural work force, covering 3.8% of stock farmland and 2% of sown land. Private farms and small family plots, which together constitute about 8% of the agricultural land, and produce as much as 33% of the nation's agricultural products suffer a severe infrastructure problems. The Russian agricultural sector was geared towards large collective state farms and accordingly there is no structure to provide farmers with credit, insurance, small scale equipment or expert advice.

The major law on land privatization was issued in December 1993. It gives the right to own land and dispose of it freely. The reform process in the agricultural sector has begun and the necessary legislative groundwork has been laid. However until the infrastructure and other problems are resolved farmers will be reluctant to leave the state farms t stake out on their own and until they do so in massive numbers the agricultural shortages will continue.

CHAPTER II: CURRENT ECONOMIC CONDITIONS.

II

CURRENT ECONOMIC CONDITIONS.

ANALYSIS OF 1992-1993. The years 1992 and 1993 were characterized by a deep crisis of falling GDP, physical output and living standards. At the same time inflation soared and unemployment slowly increased. This fall in output was not caused by a restrictive domestic fiscal and monetary policy - they have actually been too lax - but it is mainly the result of the lack of a clear coordinating mechanism's in the production and distribution system of the state enterprise. The system of state orders has been abandoned and enterprises do not find it profitable or because they cannot afford or obtain the required inputs. This difficulty will lessen in time as managers get used to market oriented systems of distribution and the continued progress of the privatization process. But in the meantime the consequences of reform on the production levels have been disastrous.

As separate enterprises and even industries are privatized they are forced to function in a market place that is still dominated by monopolistic state owned producers. In addition such free market attributes as business services, accounting and consulting firms, financial institutional, wholesale organizations, information and credit rating agencies, and even business press publications are scarce, inexperienced and inadequate. Also, the previous system of industrial ministries destroyed the established relationship and planning agencies were eliminated as well. Newly independent or privatized enterprises are forced to establish new relationships, find new suppliers, buyers, marketing channels and partners. The research and development arms of the ministries have also become separated from enterprises reducing innovation and making it difficult to increase productivity or adapt new products. The other implication of independence or privatization is the fact that the management teams are now forced to do their own planning, a totally unfamiliar practice coupled with the erroneous belief that planning of any kind and free market capitalism do not mesh. In addition such unfamiliar decisions as price setting, marketing strategies, labor negotiations, new product development are required from managers that have never done such things and have nobody to ask.

The Russian Ministry of Economics puts the decline in GNP as a percentage of the previous year at 2% in 1990, 9% in 1991, 19% in 1992 and 16% in 1993. In total a 39% in four years.

In 1992 the GDP reached 20 trillion rouble's with its deflator rising to 1,890% and the national income reached 15.6 trillion rouble's with a deflator of 2,120%. The physical output consisted of 81.2% of the 1991 levels. Retail trade declined by 39%, manufacturing by 18% and agriculture by 8%. Sales of major durable and soft goods dropped by 35-44%. The service sector also dropped by nearly 40%.

Output of consumer goods also declined. Its volume amount was 4.7 trillion rouble's, which is a 15% decrease against 1991 in comparable prices. The prices of food stuff fell more than 18%. At the same time profits in the corporate sector rose by a factor of 8 to 8.1 trillion rouble's, mostly due to inflation. Total corporate debt increased to 12.4 trillion rouble's. Of these 39 % were subsidized loans to strategic industries.

A deep economic crisis continued in Russia in 1993. The production continued to fall with GNP falling by 14 - 16 % as compared to 1992, industrial production fell by 17.2%, production of consumer goods by 11%, capital investment by 6%, and the value of provided services by 11%. The Federal budget was under a great strain. The revenues were falling due to the recession while the pressure to increase spending on social programs to compensate for declining standards of living as well as subsidies to struggling state enterprises to avoid layoffs. At the same time there was a dire need to lessen inflationary pressure.

However with all these dismal figures there were some signs of a free market at work in that the production of successful products increased or decreased just barely while the production in inefficient items such as VCR's fell drastically. At the same time production of cars, refrigerators, TV sets, carpets, publications, cheese, sugar, daily products and alcoholic beverages rose fueled by a rising demand.

WESTERN ASSISTANCE AND ITS IMPACT. There are several different aid packages under consideration. The most important one is the agreement to begin rescheduling of the \$15 billion out of the Russian debt to 18 countries of the Paris club. The deal calls for only \$1.95 billion in payments instead of the scheduled \$40 billion in 1993. The rest will be amortised over the next ten years. Negotiations with the London club of over 600 commercial bank creditors to which Russia owes about \$45 billion is also under progress.

Of the new international aid the Tokyo meeting of the 'Group of seven' outlined major areas of Western financial assistance. It includes IMF stabilization funds of US \$6 billion, IMF stand-by

credit facilities of US \$ 4.1 billion to improve balance of payments, bilateral export credits and guarantees of around US \$10 billion to western firms supplying their products to Russia. The European Bank for Reconstruction and Development has set up a fund of US \$300 million, to help in the development and promotion of small and medium size businesses.

The Russian government and reformers are unhappy about Western assistance levels and their form. Their argument is that despite continued aggravation of Russia's economic situation, the West only offers financial assistance in the form of high interest credits and not as free aid line that was extended when economic reforms were conducted in Japan and Germany. In addition the processing of most IMF, IBID and EBRD credits will take a long time and are burned with economic conditions that are difficult to obtain.

ECONOMIC FORECAST: 1994. The Ministry of Economics predicted a decline of 5% in GDP, as opposed to a 12% drop in 1993 and 20% in 1992. Also a 6% decline in industrial output and a 5% slump in agricultural was forecast. Monthly inflation rates were predicted to be 16% by March and 5-7% by the end of 1993. These predictions could be significantly off, especially the inflation figures, if the new cabinet pursues new policies.

The European Bank for Reconstruction and Development also published a forecast for 1994 from several international organizations including OECD, UNESCO, EC and Plan Econ. Decline in GDP is predicted to slow, unemployment to rise or become more open and annual inflation to slow as well. Plan Econ even goes as far as to predict a 3.5% annual GNP growth in 1995-1997. IRBD and UNESCO predict a 2-5% growth for the entire FSU in 1998-2012.

CHAPTER III: TRADE AND CURRENT ACCOUNT STATISTICS.

III

TRADE AND CURRENT ACCOUNT STATISTICS.

BACKGROUND: Russian trade is in a state of chaos. The old trading structures continue to crumble. The centralized import/export organization disintegrated while the new small scale private trading enterprises flourished. Before 1986, foreign transactions were tightly controlled through a central plan and the foreign currency budget. Approximately 70% of trade has been done on a clearing basis with socialist countries, Finland and India.

Historically, trade with CMEA (Council For Mutual Economic Assistance) countries accounted to over 50% of Soviet exports and imports. FSU was the net exporter of heavy industrial goods and a net importer of consumer goods. This trade served to subsidize other CMEA countries every year by price and exchange rate manipulations.

Since 1986 the government has taken steps to break the central monopoly on trade and stimulate the growth of exports. By creating the quasi government Foreign Trade Organization (FTO) in some sectors and allowing others to export independently. The new network was clumsy and ineffective with trade suffering a significant decline. This led to the explosion of small private trading organizations which made large profits but were unable to cope with the scope of trade.

All the FSU Republics clearly experienced a trade collapse not only among themselves but also with other countries in Eastern Europe and with developed market economies. The total volume of trade declined due to the overall fall in production, decline in exports to former socialist countries, as well disruptions in the infrastructure.

The dissolution of the Soviet Union led to the decline in the efficiency of the payment system and significantly increased the transaction costs of trade among its members. There are clear signs of falling back on less efficient but less risky payment methods such as barter and foreign currency. With the creation of the Interstate Bank to act as a multilateral clearing and settlement organization in the rouble zone the situation has improved. The collapse of the rouble zone, however can make this new bank obsolete in the near future.

1993: AVAILABLE STATISTICS AND ANALYSIS. Volume of international trade fell by 23% in the first half of 1993 to 27 billion USD.

While the main trading partners remain in Europe (68% of total) the volume has been steadily falling. The trade volume rose only with Asian countries: China-24%, Turkey-25% and Iran-166%. Trade with the United States fell by 39% and with Canada by 35%. Total trade with American countries average only 7% of total trade volume.

Total exports fell by 3% to USD 18.2 billion. Over 60% consisted of petroleum products, 9% heavy machinery. Total imports fell by 49% to USD 8.8 billion. Most imports consisted of consumer products.

The composition of Russian Exports and Imports (in million USD).⁴

EXPORTS:

PRODUCT	Jan. - Oct. 92	Jan. - Oct. 93	93/92.
Minerals	150	125	84%
Coal	593	530	89%
Crude Oil	6,726	7,115	106%
Petrochemicals	380	824	220%
Natural Gas	6,116	6,116	93%
Timber	363	540	148%
Machinery	945	961	83%

IMPORTS:

PRODUCT	Jan. - Oct. 92	Jan. - Oct. 93	93/92
Meat	365	94	26%
Citruses	14	24	170%
Grains	3,726	1,286	34%
Wheat	2,300	846	39%
Sugar	1,001	729	73%
Medicine	879	203	23%
Clothing	1,416	761	54%
Shoes	665	171	26%
Machinery	11,225	5,251	49%

There is a surprising trade surplus of USD 7.4 billion and this needs clarification. With the deduction of the barter and clearing operations the surplus falls to 1 billion and without the gold sales it becomes a deficit.

⁴russia's international business, informbank, 1994.

CHAPTER IV: FISCAL DEVELOPMENT AND MONETARY POLICY.

IV

FISCAL DEVELOPMENT AND MONETARY POLICY.

INFLATION. Russia has had a high inflation rate since the collapse of the communist economic system at the end of 1991. The initial jolt was given by the government liberalization of prices at the end of 1991 and the beginning of 1992. Most prices were decontrolled while the monopolistic nature of many industries remained the same and many enterprises remained state owned. This situation led to the monopolistic price setting and resulted in an even higher jump in prices than could be expected after the liberalization of prices that were virtually frozen for 70 years.

After an initially tight monetary policy in the first quarter of 1992, the Central Bank of Russia loosened credit for the rest of the year. The flood gates truly opened in the third quarter of 1992, fueled by huge credits to state enterprises, loans to government and to other Republics to finance their trade deficits with Russia. The central Bank acted in cooperation with the Supreme Soviet in an effort to prevent further decline in output. The Ministry of Finance was bitterly opposed fearing a rise in inflation. "We increased the volume of credits in order to prevent a further fall in output and investment. But by late 1992 recession had slightly slowed down, and we began to take restrictive measures," say's Mr.Khandruev⁵. This view contradicted the position of the then Minister of Finance Mr.Fedorov and many international economists who thought that the monetary policy was already too lax and that the fall in output was caused by the breakdown of industry relationships.

At any rate, the following chart demonstrates the growth of the money supply in 1992 and the first part of 1993. The cause of inflation becomes obvious.

Average Monthly Rate of Money Supply Growth (%)⁶

	1992				1993
	I	II	III	IV	I
Money Supply(M3)total	12.7	15.4	29.1	17.1	15.0
including:					
Cash Money	14.3	22.5	27.8	21.8	14.9

⁵cruel to be kind, economist, december 1993.

⁶emerging market indicators, economist june 1993.

Non-Cash Funds	12.3	13.7	29.5	15.8	15.1
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The Central Bank kept its refinancing rate at 80% between May 1992 and 1993 while the consumer prices rose by a factor of 24%. Alongside cheap direct bank credits to the enterprises, massive explicit subsidies were channeled from the state to the enterprise sector. In addition Central bank lending rates to Commercial Banks, and in turn their lending rates to the public remained negative until December 1993. This led to hyper inflation with figures reaching nearly 35% per month in 1992. The efforts by the Ministry of Finance to stem this tide were only partially successful when the Central Bank decreased emissions in 1992. The agreement was short lived. As the 1993 summer harvest season approached, the Central Bank initiated a new wave of agricultural credits, with the total credit expansion by the bank equalling 40% of the annual GDP. The inflation pattern has roughly followed these ebbs and flows of monetary growth with a lag of about four months.

The consumer price index rose by 344% in 1993, fueled by a twofold increase in fuels, transportation tariffs, rents and liberalization of coal prices.

Rise in Monthly Consumer Price Index.⁷
Percent to previous month.

MONTH	1992	1993
January	345	126
February	138	125
March	130	120
April	122	123
May	112	119
June	119	120
July	111	122
August	109	126
September	112	123
October	123	120
November	126	116
December	125	120
Yearly Average	139	121

The total inflation for 1992 caused a price increase by a factor of 26 and in 1993 it was 1,300%.

⁷emerging financial markets, economist January 1994.

RUSSIAN FOREIGN DEBT SITUATION: Total external debt has increased drastically since the start of the reforms in 1985. During the first phase in 1985-87 the debt rose from 29 billion USD to 39 billion. During the second phase of 1987-90 it rose to 52 billion. At the same time foreign currency reserves fell from 13 billion USD to only 5, while debt services rose from 8 billion to 13 billion USD.

As of the end of 1992 the total Russian external debt stood at 74.6 billion with 2.8 billion in overdue interest. During the first quarter of 1993 the debt decreased to 72.5 billion but the overdue amount increased to 4.7 billion. Debt on medium term credits totalled to \$32.7 billion, down from \$36.3 billion on January 1. The debt on commercial credits was \$7.2 billion as of April 1, 1993 up from \$6.6 billion at the beginning of the year. The debt to foreign governments was about \$35 billion while to commercial bank creditors, between \$ 16-25 billion.

Loan defaults by foreign governments on debt to Russia amount to USD 5.1 billion. A significant part of these are considered uncollectible. Over \$7 billion in Russian loan payments were rescheduled. Total foreign debt increased by \$11.4 billion. Total capital inflow was positive however capital in flight tendencies have escalated. Foreign currency reserves of the Central Bank rose to \$4.1 billion mostly due to IMF credits.⁸

CAPITAL FLIGHT: While foreign credits amounted to 12.7 billion the positive balance of capital inflows amounted to only 7.1 billion. The apparent difference was kept by exporters in offshore accounts in violation of existing legislation. The total economic damage was calculated by the Central Bank to be over USD 6 billion. This allowed Russian commercial banks to significantly expand their offshore deposits. Legal capital flight alone, expressed in correspondent balances in offshore banks, amounted to \$4.1 billion in 1992. Another contributing factor is the large grey market for unregistered and illegal exports. Many companies evade government quotas and export licensing requirements by exporting their products through intermediaries and former Soviet Republics and keeping most of the proceeds abroad. Many companies deliberately lower the official price of their exports while channelling the remainder into offshore accounts.

Total capital flight amounts to up to \$17 billion. This creates an impression on the part of Western creditors that Russia should be able to increase its debt payment to more than the current 2-3

⁸policy research division, world bank, 1994.

billion a year. This could be done only if the capital flight could be stopped. In order to do that far more stringent currency and custom control as well as a significant improvement in the tax collection system. Weak custom control on the CIS borders due to budgetary constraints, massive corruption and the mafia influence would hamper these efforts for a significant period of time.

CHAPTER V: SOCIO-ECONOMIC FACTORS.

SOCIO - ECONOMIC FACTORS.

LABOR SITUATION. Under Russian statistical definitions total capable labor force, or all those by age and health able to work, consisted of 86 million. Total number of employed was 72 million. Just over 1 million people were registered with government unemployment agencies. The difference of 13 million between labor capable and employed/unemployed is explained by theoretically employable people choosing not to work. Of the 1 million registered 700,000 were classified as unemployed and 65.7% received unemployment benefits. In addition over 3 million workers were underemployed of which 1.9 million were furloughed with partial loss of salary. It is estimated that 11% of workers in the industry are now employed part time and that the total latent unemployment is estimated at 15 million. Furthermore, over 83,400 enterprises employing over 26.2 million workers or 36% of the work force have announced plans to cut back on production and to restructure. Under such conditions it is estimated that open unemployment will reach 2-3 million in 1993.

The percentage of female participation in the economy is very high by western standards. In addition, Russian women work longer hours since part time work is virtually non-existent with 99% employed full time. In December 1993 Yeltsin raised the minimum wage from 7,740 to 14,620 rouble's a month. Stipends to students and other transfer payments were amended accordingly. The living standards that were never high in the FSU have fallen drastically. The average Russian has cut consumption to 40% of the 1991 level. Every third citizens on or under the poverty line of 10,000 rouble's per month, this is 42% of the country's families. The average family spends about 65% of its income on foodstuff and the lowest one third spends as much as 80% of their income on a diet dominated by bread.

LIVING STANDARDS. The average monthly wage as of September 1993 are as follows:

RUSSIAN WAGES: SEPTEMBER 1993

INDUSTRY	AVERAGE WAGE
Culture and Art	50
Science	55
Agriculture	50

Education	60
Health	67
Public administration	80
Industry	77
Construction	110
Transportation	120
Finance	160
Overall average	60*

*All wages are in thousand of rouble's.

Living standards that were never reasonably high in the former Soviet Union have drastically fallen. Now the average Russian has cut his consumption to 40% of the 1991 level. Every third citizen is or under the poverty line of 10,000 rouble's per month, this includes 42% of the countries families. The average family budget includes up to 65% spent on foodstuff while the lowest one third spend as much as 80% of their income on a diet dominated by bread. In 1992 consumers spent 63.9% of their income on goods and services, 10.1% on statutory payments and various contributions, and 4.5% on savings. Cash money on hand grew by 1.4 trillion rouble's, or 21.4% of the cash income, which corresponds to the 1991 level.

The average monthly income per capita in Russia as of November 1993 was 37,908 rouble's which constituted about \$25 at the official exchange rate of the period. For the employed it was sightly higher 42,799 while for pensioners it was 26,705.⁹

Survey of opinions of Russian's as to what their economic future looks like.¹⁰

Question 1: Economic outlook for Russia over the next five years.

Conditions will improve a great deal	23.2%
Conditions will improve somewhat	58.9%
No significant change will occur	11.4%
Conditions will deteriorate somewhat	3.6%
Conditions will deteriorate a great deal	2.9%

⁹central european business information service, January 1994.

¹⁰reforming russia's economy, economist december 1993.

Question 2: Economic outlook for Russia over the next 12 months.

Conditions will improve a great deal	5.7%
Conditions will improve somewhat	43.8%
No significant change will occur	31.6%
Conditions will deteriorate somewhat	13.8%
Conditions will deteriorate a great deal	5.1%

Question 3: Most important step towards improvement in the economy.

Maintaining a stable rouble exchange rate	26.1%
Adopting a simpler system of taxes	26.5%
Improving the local infrastructure	7.9%
Developing stronger foreign trade ties	11.3%
Educating the work population about free market	12.1%
Reducing government subsidies to industries	6.7%
Increasing government subsidies to industry	9.3%

Question 4: How would you assess the political situation in Russia today?

Development of democracy	14%
Preservation of the old order under new names	17%
Establishment of a dictatorship	7%
Loss of order, increasing anarchy	42%
Hard to say	20%

Profile of all respondents:

Owners	3.3%
Self-employed	28.5%
Consultants	16.4%
Agents	7.9%
Managers	31.0%
Investors	1.2%
Joint venture participants	11.9%

The attitude of the people are extremely important for the success of the reform process. The feelings towards the reform process remains ambiguous. While the people seem to approve of reforms in principal most are disenchanted with the realities. Asked whether they consider the reform process to go to slow, just right or too fast, 64% opted for the first option and only 5% and 4% for the latter two. However the overall approval of the market system is still significant: 54% of the population feels that the effort to

convert to a market economy is good for the country's future while only 25% feel the process to be harmful. On the other hand 39% that the chosen methods of reform are wrong while 33% agree with the governments choices.

Russian business executives are moderately optimistic about their economic future. Most feel that their conditions will improve, however most also feel that the improvement will come later rather than in the near future. Support for radical economic measures is also weak while such perennial free market concerns as tax systems and education shows strength.

CHAPTER VI: FINANCIAL MARKETS IN RUSSIA.

VI

FINANCIAL MARKETS IN RUSSIA.

STOCK EXCHANGES AND BOND MARKETS: The first year of major activity and development in the Russian security market was 1991. The rapid growth was encouraged by the emergence of the legislative basis for security trading. Laws on 'Enterprises and Entrepreneurial Activity', 'Joint Stock Companies', and 'Issue and Circulation of Securities and on Stock Exchange'. Several types of securities are currently being traded on the Russian equity markets. They include privatization vouchers, stocks of newly privatized and fully private companies, four types of government securities and foreign currencies. The major stock exchanges are Moscow Central, Moscow International, Siberian and St. Petersburg Stock Exchanges. Five major groups of institutions involved in securities trading include commercial banks, private industrial enterprises, commodity and stock exchange, investment companies and mutual investment funds, trading and industrial companies. Stock remains the major securities traded. Commercial Bank stocks have been the most active offering high dividends of 150 - 200%. Bank shares take up as much as 50% of all shares traded.

COMMODITY EXCHANGE: Commodity Exchanges have played an important role in Russia's modern history. They became the first really large institution to pave the way for market development. They introduced new techniques of trading and price formation that afterwards were implemented by the market. Finally Commodity Exchanges offered an unprecedented example of spontaneous renaissance and growth of private enterprises.

Commodity Exchanges of 1988 - 1992 have played a major role in the developing of a free market. They were significantly flawed in the price formation and 'after-market' activities but they showed the way for free market price formation and exchange of goods replacing the formerly centralized distribution system. Several steps were taken by the government towards improving the operation of Commodity Exchanges in 1993. The government considers the Commodity exchanges to be instrumental in a free market system and aims to increase their activity and even channel government purchases through the exchange in future.

COMMERCIAL BANKS: As of April, 1993 there were 5,627 Commercial Banks registered with the National Tax Service. Before the reforms the banking system was monopolized by 4 government structures. The Central Bank and 4 specialized banks for financing long term investment in industry (Promstroibank), agriculture (Agroprombank),

communal and social services (Shilstosbank), and a savings bank, were the privileged institutions permitted to operate in the country.

Decentralization and de-monopolization policies introduced early in 1990 brought the 'two level' structure. While the Central Bank still remains at the top of the system newly born commercial banks have begun to mushroom during the last three years. Nearly 6000 new establishments (headquarters and branches) are functioning at the retail level. Almost a third of the new banks have their origin in the former three major specialized banks who preferred to grant their ex-affiliates autonomy. There is a significant international participation in the Russian banking system. Russian bank are now allowed to participate in ownership of foreign financial institutions and banks. This requires special permission from the Central Bank.

There are still serious problems in the Russian banking sector. The capability of the banks to screen the credit worthiness of prospective borrowers and to monitor their activities is limited, the extensive use of directed credit programs limits the role of the bank to passive intermediaries, inside lending is a wide spread phenomenon and the negative interest rates continue to prevail. Many banks are severely under-capitalized, have a weak deposit base and they have a weak loan portfolio with a sizeable portion of bad and unrecoverable loans.

PRIVATIZATION EFFORTS. Nearly three years ago, Russia embarked on the crucial part of its effort to become a market economy: selling the property of the state that once owned everything and thus founding a nation of property owners with a stake in the success in economic reforms. When the end of price controls wiped out savings, the Government chose to conjure up a middle class by giving away most of state property, issuing 144 million vouchers free to every Russian to turn into shares.

Now with most businesses and two-thirds of the Russian work force formally under private control, the voucher program has effectively ended and real capitalism, using real money finally begins. This second stage will be the stiffest test of whether the free market will really catch on in this vast distorted economy. Private companies are being thrown into a perilous environment where credit is hard to get, debt among companies is are high, management is weak, crime is rampant, taxes are punitive and consumers are poorer than they were three years ago.

In July 1994, with some exceptions, the government, began selling its remaining enterprises - for cash, not vouchers. The companies,

many of which are starved for capital, are to get 51% of the purchase price. Private enterprises will also be able to sell land, and private investors should now be able to exercise more control over management.¹¹

FUTURE OF PRIVATIZATION: A privatization program for 1995 is being prepared for submission to the new Federal Assembly by the State Property Committee. Under the proposed program, about 100 large enterprises with capital of more than 1 billion rouble's will be targeted for privatization. For the most part these enterprises will be in the oil and gas sector, automobiles and machine tool building. The draft plan would also make it easy to privatize enterprises in the defense industry and land. In addition the privatization of export agencies owned by the Foreign Economic Relations Ministry is anticipated with the government maintaining controlling interest in the main commodity export agency.

PROBLEMS: Russia's stock market has emerged with astonishing speed. The first stage of mass privatization, which began in December 1992 and ended in June 1994, put more than 14,000 large and medium-sized enterprises and their workers into private hands and created 40m shareholders. Many of these shares are now worthless, either because their issuer is bankrupt in all but name, or because no one will make prices in them. However, there is now a liquid market in the shares of the 50 largest companies. This market is not for the faint hearted; prices move with stomach churning speed. For eg. the shares in Perm Motors, a maker of aircraft engines, fell by 43%(in dollar terms); shares in Kamaz, a maker of trucks, rose by 29%. Shareholders can be treated roughly.

If Russia's stock market and privatization efforts are to gain credibility, it needs to establish a few basic rules, enforced by a credible regulator. These include establishing shareholder rights, clarifying who owns the land on which privatized enterprises are sitting, and establishing a central depository and custodian for shares to make the secondary market more liquid. Since it has a residual stake of around 30% in nearly all of the privatized companies, and stage two of privatization involves selling these stakes to finance government spending, it is in the interest of the government to get these things correct.

What is surprising is that Yeltsin has entrusted the next stage of the privatization efforts to Valdimir Polevanov, whose only conceivable qualification is that he is loyal to Yeltsin. His views on privatization until now have been alarming, "Like day has

¹¹lurching into the capitalist era... new york times, july 1994.

night and life has death, privatization should have nationalization." He feels that the reckless denationalization of the aluminum, energy and defense industries has damaged Russia's national security. He feels that foreigners should not be allowed to buy stakes in these sectors as it is bad for Russia's security.¹²

The US is spending \$13 million annually to help Russia in its privatization plans.

¹²the problems of polevanov, economist January 1995.

CHAPTER VII: INVESTING AND OPERATING IN RUSSIA.

VII

INVESTING AND OPERATING IN RUSSIA.

There is precious little information and hands on advice for western companies operating in Russia. New rules are constantly being adapted, reworked, withdrawn and changed. Some laws come out including deadlines long passed. In some areas there are no laws and regulations governing economic activity at all. In addition, with the absence of common law, one cannot look to courts to provide guidance. Contracts are unenforceable and government regulators are often corrupt. Accordingly it is necessary to understand as much as possible about the rule of the game before investing or even making a decision to invest.

The following are some of the rules that an investor in Russia should follow:¹³

Rule 1: If you want to be making money in Russia ten years from now, you have to get to work now. Russia is no place for fast deals. Negotiations are protracted, putting together a deal involves many steps; the language barrier is enormous, it takes a long time to build up trust, trust is vital. Market research is very important as the information and statistics are less than satisfactory. Financial statements are prepared without any recognized or uniform accounting statements and are unaudited.

Rule 2: Good partners, not legal recourse are a foreign investors best protection in Russia. Business is based on friendship and personal understanding.

Rule 3: Western companies that do best are the ones in which the top management get personally involved and the country reams are stable. The buck still stops at the top in Russia. Lower ranking business officials have little independent authority.

Rule 4: Begin small locally. In contrast with experiences of doing business during the time of the centralized Soviet system, the projects that are making money in Russia today are not the big deals negotiated at the top of the government, but the smaller ones that have begun at the lower level.

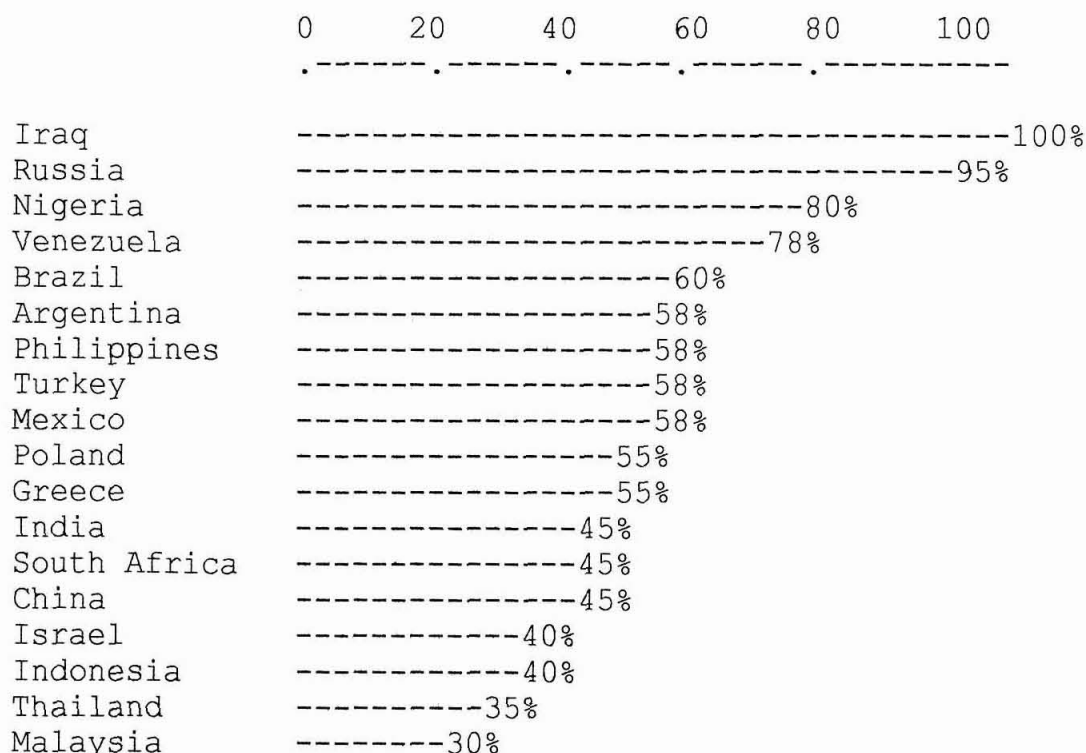
Rule 5: Do not insist on full formal control. This is the most difficult rule for Western companies, because it is the hardest to justify to banks and boards. Full formal control is the most sensitive issue in the business world of Russia. Full western ownership, without a Russian partner is the most controversial of all.

¹³Russia 2010 and what it means for the world, by daniel yergin and thane gustafson

GENERAL OPERATIONAL DIFFICULTIES. Important operational problems often cited by foreign investors, include the hiring of Soviet workers, quality control, finance from foreign sources, political risk insurance, custom duties and tariffs and a relationship with the local government. There is no clear legal frame work governing relations between the joint venture and the government at local or federal levels. The most serious operational problem stems from the difficulty in developing a reliable means of securing supplies. Management is another problem as there is a lack of trained managers and key employees, there is a lack of understanding of marketing principles, of ones competition and how to cut down costs.

Predictably, a host of other problems associated with poor infrastructure such as domestic and international communications, office facilities, banking and related financial services, housing and other amenities are also a major barrier to Western investors. Additionally the lack of enforceability of contracts and the lack of organized dispute settlement are problems as, old Soviet courts are ill prepared to deal with new economic disputes and laws are unclear and sometimes contradictory.

COUNTRY-RISK RATING. ¹⁴



¹⁴emerging-market indicators, economist, december 1994.

Chile	-----30%
Czech Republic	-----30%
South Korea	-----25%
Hong Kong	-----20%
Taiwan	-----20%
Singapore	--10%.

TAX SYSTEM. The tax rates in Russia remain high in comparison with US policies:

Employer payroll	39%
Employee payroll	1%
Income(top marginal)	30%
Income(lowest marginal)	12%
VAT (standard)	20%
Corporate (standard)	32%
Capital gains	30%

The estimate of the total effective tax rate given the above combination of taxes ranges between 55% and 63% depending on the model used. The effective tax rate on capital income is an astonishing 97.8%. These effective rates are about 15-20% higher than in other Central European countries but is on par with other FSU republics.

Indirect taxes have remained a key source of revenue, especially due to the introduction of VAT. New profit taxes are to play a more important role in the future due to their importance to a market economy. However due to inflation and weak government control leading to tax evasion and late payments are significantly eroding the government revenue base. The VAT is assessed to foreign goods at the point of entry. It covers foreign currency sales and is to be paid in foreign currency. Food, medicine and children's clothing are untaxed. Profit tax is collected in advance payment biweekly from enterprises and quarterly from joint ventures. Tax on excess wage increases is assessed and paid quarterly. Wage income tax is withheld from the payroll and the withholding is final; no annual adjustment is made. For the self employed advance payments are due quarterly and the annual form is filled by January 15.

The major problem with the tax situation in Russia, however, remains the fact that no clear collection and disputer resolution procedures are established and many items remain unclassified and undefined.

BANKRUPTCY LAW. The Russian parliament approved a bankruptcy law

on 12 November 1992. Although it was expected that enforcement would begin in March 1993, the Russian government acknowledged in February 1993 that it would not attempt to enforce the bankruptcy laws due to the perceived lack of resources.

Securities Regulations. Current securities regulations are underdeveloped and unsophisticated but an effort is on the way by German and British teams to draw plans for new rules. Current rules establish a mechanism for conducting both public and private placement of securities. Initial offerings by a joint stock company must be registered with the Ministry of Finance, unless offering exceeds one billion rouble's, in which case Federal approval is needed. Placement of banking company stock must also be registered with the Central Bank. Private placement, require a signed application accompanied by notarized corporate document and a management decisions statements including the terms of issuance, the use of the proceeds and the list of investors. Public placement must include all the information required of a private placement plus a prospectus, all of which must be available to potential investors and the mass media.

MAFIA INFLUENCE. During the years of reform a new and dangerous phenomenon emerged in Russia. After 70 years of total police control the dismantled KGB and ousted Communist party officials joined the growing organized crime divisions. By some estimates these organizations now control as much as 60% of all commercial structures in Russia. They are especially prevalent in the most profitable and easy to control sectors such as retail, whole sale and international trade. Now they are starting to move into more profitable, lucrative and bigger industries such as banking, real estate and mineral exports.

The explosion of criminality in Russia is due to the enormous money being to be made in the Russian market. Most of the countries assets are up for grabs. Moreover, Russia's economic potential, both as an exporter and as a market, is so large that the first entrepreneurs to commercialize a given sector can earn vast profits.

CHAPTER VIII: FOREIGN DIRECT INVESTMENT IN RUSSIA.

VIII

FOREIGN DIRECT INVESTMENT IN RUSSIA

IMPORTANCE: The presence of a positive FDI flow is extremely important for the progress of reforms. To the extent that more FDI improves the supply side flexibility of the economic policies and generally stimulates growth, it contributes to the success of the reform programs, reduces the probability of their reversal and may thus also add to political stability. By exposing public administrators to market-based thinking, early foreign investors may contribute to smoother bureaucratic procedures and less discretion in the future. By increasing the competitiveness of markets, they may speed up the process of relative price realignment. By their presence, they may induce a private provision for a financial and distribution infrastructure, thus enhancing information and reducing transaction costs. In contrast, the absence of a positive FDI can be a factor in stymieing reform efforts by prolonging the transition and thus increasing the probability of policy reversal.

TOTAL FDI IN RUSSIA: Few, if any countries offer as potentially attractive opportunities for large scale foreign direct investment as Russia. It possesses a vast internal market, a critical need for an efficient and expanded consumer goods industry. It has enormous natural resources whose efficient exploitation would yield large benefits both to Russia and to foreign investors. It has large untapped business opportunities resulting from the conversion of the defense industries, a woefully underdeveloped service sector - including the basic distribution system and business-related services, where foreign know-how would be extremely valuable and the general need to import foreign technology, managerial skills and experience in operating in a market environment.

The total foreign direct investment in Russia has been minimal to date in terms of foreign capital actually invested. The main factors hampering investment are inadequacies in political stability, economic and in the regulatory environment.

Among the investors, US corporations proved by far the most active with more than triple the number of deals than the next most active country, Germany. South Korea was a surprising third, with other European countries and Japan closely following. In total investment value, however Cyprus emerged as a surprising leader. Considering the fact, however, that several billion US dollars in Russian flight capital is hidden in Cyprus, the surprise evaporates. In reality Russian banks and exporters are channeling

the off-shore capital back into Russia through fronting Cyprus companies. Among the true foreign investors the US retains primacy, South Korea with its Siberian investments is second and Germany, France and Italy closely follow. In joint ventures alone the US dominates closely followed by Germany.

Foreign Direct Investment in Russia is being distributed into several major areas of the economy. Investment into the oil and gas industry, spurred by the Framework Agreement on Oil and Gas between the World Bank and the Exim Bank of the US leads the way, several other industries are proving attractive for foreign investors. Electronics and Telecom sector has actually attracted higher number of deals than oil and gas, albeit lower in total value. The automotive, aerospace, hotels, mining and banking industries have also attracted investment interest. The trend in joint ventures alone is somewhat different. As much as 80% of these are dedicated to the service sector.

CHAPTER IX: CONCLUSION.

IX

CONCLUSION.

When writing about the prospects of the states of the former Soviet Union, observers confront the same problem that baffled them in 1918: not only is it hard to guess where the region is headed, it is also unclear how far the disintegration from a unified empire to splintered sub-parts will go. So severe and complex is the crisis that the only certain fact is the existence of innumerable uncertainties. This makes it inordinately difficult to estimate the region's ability to prepare for the twenty-first century, since its leadership is primarily concerned with surviving the present chaos and its people are overwhelmed by the daily need to make ends meet. In such circumstances little energy is left to consider global trends, let alone adjust to newer challenges.

Four years of radical economic reform have failed. Shock therapy has made inflation worse, not better. A few people have grown rich but most face poverty. Crisis threatens: at best widespread social unrest, at worst a decent into anarchy. The problem at present is too little reform, not too much. To understand this one has to go back to Gorbachev and the beginnings of post communist Russia. Gorbachev's greatness lay in his capacity to destroy everything he tried to save- his party's monopoly on power, its ideology and its empire. As for economic reforms, "virtually every mistake that could be made was made" by, Gorbachev.¹⁵ By the end 1991, Russia's share of the Soviet Union's budget was equal to 31% of Russia's GDP. Industrial output-the collapse of which is now blamed on reformers-fell 19% in 1991.

Gorbachev's last two Prime Ministers, Nikolai Ryzhkov and Valentin Pavlov, spent all the Soviet Union's foreign-currency reserves trying to conceal the disaster. Its own money gone, the government appropriated \$10 billion deposited by Russian and Foreign companies in the state-owned foreign exchange banks. At the end of 1991, the Soviet Union collapsed. Boris Yeltsin was elected president of Russia, he appointed a team of reformers lead by Gaidar to sort out the mess. Foreign reserves were very low, the shops were empty and there appeared real danger of widespread hunger in big cities.

According to Grigory Yavlinsky, an economist who is one of Gaidar's main political rival, the Gaidar team's great mistake was to liberalize prices before breaking up the monopolies which had

¹⁵anders aslund in the economist, december 1993.

dominated the Soviet economy.¹⁶ In an ideal world, Yavlinsky's prescription would have been correct. But there was nothing ideal about Russia in the Summer of 1992. The priority was to get goods into the shops and the only way to do that was by liberalizing prices. In January Gaidar lifted price controls from 90% of traded goods. By the next day prices had risen by an average of 250%. That was the bad news, the good news was that the shops quickly began filling their shelves.

Western aid has been pouring into Russia in an attempt to prop up Yeltsin and democracy. The West should resist the urge to pour in aid indiscriminately, especially in the light of Russia's election and the rebirth of militancy. Government -to-Government transfers will not help Russia, like transfers to third world countries has not helped them develop. Aid to a certain extent has institutionalized corruption, entrenched atavistic institutions, and side lined the private sector to the black market. The Western nations in an attempt to help , should encourage the Russians to introduce reforms to stimulate entrepreneurship, enter into free trade agreements with Russia and the struggling ex-Soviet republics, promote private investment by eliminating -incentives to it in their own countries, help finance mass privatization of the russian economy, forgive or restructure the foreign debt incurred by the FSU and finance the dismantling of nuclear weapons.

Russia on the other hand should be advised to establish a regime of low taxation and minimal regulation, uphold and expand private property rights under a rule of law, and establish investment laws and trade policies that would attract foreign capital and stimulate rapid growth of the private sector. Another way in which the West can help the FSU is by removing all trade barriers. Nations that have received most Western aid since World War II report that lowering barriers to trade is far more helpful to their development than are large amounts of Government-to Government aid transfers.

Once and for all, the West should end its out-dated reliance on large scale government-to-Government aid. The world can ill afford the consequences of turning Russia into a international welfare dependency. Massive aid to Russia only would entrench unproductive institutions and prolong the crisis. A better solution is to base development on the proven success of free markets and free enterprise.

The last thing the west should do for Russia, is to get rid of Boris Yeltsin. There was a time when the world could hope for

¹⁶cruel to be kind, economist, december 1993.

great things from Yeltsin. As Russia's first democratically elected president he set out to establish , by the people's consent , a stable, free market democracy. Given the problems afflicting what is, in effect, the worlds sixth continent, that was going to be an awesome task. Yet over the last year Yeltsin mistakes have become so glaring that, even before the bloody battle in Grozny, Yeltsin the tsar of democracy had already shrunk in historical size. Still there was hope that, for all his mistakes, Yeltsin would keep the momentum of reform going and hold off the challenges from communist and nationalist forces. Now even that hope looks ready for burial. Once the reforming strongman, Yeltsin is now the wrong man to lead a reforming Russia.

What to do? We have lost our way. From afar, the Demon cries out, He is leading us astray.

-Alexander Pushkin.

APPENDIX

THE RUSSIAN CONSTITUTIONAL HIGHLIGHTS.¹⁷

GENERAL PROVISIONS AND PRINCIPLES

- Russia is "a democratic federative, rule-of-law state with a republican form of government."
- Principles of separation of powers among the executive, legislative and judicial branches, with a strong presidency.
- Fundamental principles of human rights are guaranteed.

FEDERAL SYSTEM

- The delineation of responsibility and power between the federal government and local authorities is defined.
- Local self government is recognized and guaranteed and jurisdiction is defined.

RULE OF LAW

- The constitution and federal laws are paramount.
- Republics may have their own constitution and legislation. Other localities may have their own charters and legislation.

BUSINESS PRINCIPLES

- The Russian Federation is a unified economic area.
- Freedom of economic activity, support for competition, free movement of goods, services, and capital are guaranteed.
- The rights of private owners is protected. Property may not be expropriated except by a court order.
- Land and natural resources can be privately owned. "Owners freely possess, use and dispose of land and other natural resources."
- All forms of property-private, state, municipal and other forms-enjoy equal recognition and protection.
- Economic activity aimed at monopolization or unscrupulous competition is not permitted.
- Newly introduced taxes cannot be retroactive.
- Right to inherit property is guaranteed.
- Intellectual property is protected by law.
- A minimum wage is guaranteed.
- Citizens have the right to freely dispose of their labor and choose the nature of their work.
- The right to work in a safe and clean condition is protected.
- The right to strike is "recognized."

¹⁷Russia and the commonwealth, business law report, buraff publications, 1993.

PRESIDENTIAL AUTHORITY

- Elected to a four-year term; serves no more than two consecutive terms.
- Can issue decrees and directives whose implementation is mandatory.
- Appoints the prime minister with confirmation by the State Duma (lower house).
- Appoints deputy prime minister and other federal ministers.
- Can dismiss the prime minister and his ministers and dissolve the State Duma in limited, specific instances.
- Is the supreme commander-in-chief of the armed forces.
- If unable to perform his duties is temporarily replaced by the prime minister.
- Impeachment articles are clearly defined.

POWERS OF THE FEDERAL ASSEMBLY

- Federal Assembly has two chambers, the Federation Council consisting of two representatives from each constituent part of the Russian federation, and the State Duma, which consists of 450 deputies elected by combination of party lists and individual districts.
- State Duma deputies hold four-year terms (cannot hold other positions except to serve in the government) and the Federation Council terms are to be determined later.

ADOPTING LAWS

- Legislation can be proposed by the president, Federation Council, Duma, the government, or regional legislatures. For matters under their jurisdiction legislation may be introduced by the Constitutional Court, the Supreme Court and Superior Court of Arbitration. The laws are first introduced into the State Duma then sent to the federation Council. There is a conference committee to reconcile differences but the Duma can override the council's rejection by a 2/3 majority.
- Adopted laws must be signed by the president. 2/3 vote in both houses are required for overriding the veto.

CONSTITUTIONAL AMENDMENTS

- Elaborate process is required.

JUDICIAL BRANCH

- Judges are independent and subordinate only to the constitution and to federal law.
- Constitution Court consists of 19 judges and hears constitutional issues and resolves disputes over areas of jurisdiction. Supreme Court is the highest court for civil, criminal, administrative and other cases. Superior Court of Arbitration is the highest court

for the resolution of economic disputes.

- Justices for these high courts are nominated by the president and confirmed by the Federation Council. Judges in lower federal courts are appointed by the president.

CENTRAL BANK

- President nominates the chairman of the Central Bank, which requires confirmation by the Duma. The Duma can remove the chairman or the President can recommend such removal.

- Basic function of the Central Bank is to protect and guarantee the stability of the rouble.

HUMAN RIGHTS AND FREEDOMS

- Extensive Human and Civil rights are guaranteed.

ANNOTATED BIBLIOGRAPHY

PRIMARY

(1) Erlanger, Steven, "Lurching into the capitalist era, Russia sells its factories for cash," The New York Times, July 1994.

This article contained information on Russia's privatization efforts, the progress, the problems and as to where it stands today. This article helped me to come to the conclusion that though Russia is trying to become a free-market economy it is still bereft with problems.

(2) "Emerging Market Indicators," The Economist, June 1993.

This article provided me with charts on the emerging markets in the world. It helped me conclude that Russia is the last of the emerging markets that one should invest in.

(3) "Reforming Russia's economy," The Economist, December 1993.

This article contained information on pre-reform Russia, on Gorbachev, on Yeltsin and on Gaidars reform policies and their effects.

(4) "Cruel To Be Kind," The Economist, December 1993.

This is a follow up to the earlier article. It deals with the reforms, their progress and the hardships that they have caused in Russia.

(5) "Emerging Financial Markets," The Economist, January 1994.

This article provides one with conclusive proof that Russia is the last place to invest ones money.

(6) "What Is Russian For Free Press," The Economist, January 1994.

This article was about the elections in late 1993 Russia. It deals with the rise of ultra-nationalism and gives a break down on how the parties fared in the election.

(7) "Emerging Market Indicators," The Economist, December 1994.

This article once again is about the worlds emerging markets and puts Russia as the worst market to invest in.

(8) "Problems of Polevanov," The Economist, January 1995.

This article is about Russia's stock market, its privatization efforts and the problems faced. The main thrust of the article is on Mr. Polevanov who has become Minister in charge of Privatization. it talks about how inefficient, unqualified and nationalistic he is.

(9) Kennedy, Paul; "Preparing for the 21st Century," 1993. Page 228-249.

This book is a synthesis of extensive research in fields ranging from demography to robotics in order to draw a detailed persuasive and often shocking map of the very near future. It also paints a vivid picture of the FSU and Russia and as to where it is headed.

(10) Rourke, John T; "Taking Sides," sixth edition.

This book is written in the form of a debate and is designed to introduce readers to controversies in world politics. This book provided me with information on the positive and negative aspects of investing in Russia.

(11) Schememann, Serge; "Solzhenitsyn's Deepest Russia... is it still there?," The New York Times, May 1994.

This article dealt with Solzhenitsyn, his feelings on his return to his homeland, his hopes for Russia and as to where Russia may eventually go.

SECONDARY

(1) "Central European Business Services," January 1994.

(2) The Economist.

- (a) "The Battle for Russia." October 1993.
- (b) "How to get Russia respected." November 1993.
- (c) "The House divided." December 1993.
- (d) "Sale of the century." May 1994.
- (e) "Russia.. the next crisis." November 1994.
- (f) "Why Chechnya matters." December 1994.
- (g) "The wrong man for Russia." January 1995.

(3) Policy Research Division. World Bank 1994.

(4) TIME

- (a) "Hello I must be going." January 1994.
- (b) "Move over Yeltsin." February 1994.
- (c) "If it moves, tax it." May 1994.
- (d) "A voice in the wilderness." June 1994.
- (e) "At your service." October 1994.
- (f) "Ruble or rubble." October 1994.